Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:Postf-116987-02
VLHamilton

date: May 2, 2002

to: Appeals Officer, LMSB Area 4
Attn: Susan A. Kahalekulu

from: Area Counsel
(Natural Resources:Houston)

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subject: [redacted] **Inc. - Request for Advice**

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is in response to your request for Counsel advice regarding the above-referenced taxpayer. Simultaneously with sending you this advice, we are sending it to the National Office for ten day review as a non-docketed significant advice. Please wait to act on this advice until we notify you of the National Office response.

ISSUES

1. Whether taxpayer's sales made after [redacted] are "sales on approval" under the provision of Uniform Commercial Code (hereinafter "UCC") section 2-326.

2. Even if the sales at issue are "sales on approval" under the UCC, whether the taxpayer defer accrual of the income on these sales for the [redacted] days during which the taxpayer claims to retain title.

CONCLUSION

1. Yes. No authority was found to support a conclusion that the taxpayer's sales are not "sales on approval" as provided

under UCC section 2-326.

2. The taxpayer cannot defer accrual of the income for [redacted] days.

FACTS

For general facts, see discussion of facts as stated in Assistant District Counsel Memorandum of June 12, 2000. The facts as related below are relevant to the narrowed issues on which you are requesting advice.

[redacted], Inc. (hereinafter "[redacted]") is a parent S corporation wholly owned by [redacted] and [redacted]. [redacted] files returns on the calendar year basis and reports income on the accrual method. The retail operations include [redacted] retail outlets located throughout the United States under such names as [redacted], [redacted], [redacted] and [redacted]. A related partnership, [redacted], LLC (hereinafter [redacted]") is a limited liability company wholly owned by the same two partners. [redacted] is the sole member of [redacted] and [redacted], both LLCs.

During most of [redacted], [redacted], [redacted] and [redacted] sold all of their merchandise on a cash and carry basis. The merchandise had to be paid for prior to merchandise pick-up. It is the customer's responsibility to remove the purchased items from the stores unless they requested and paid for delivery. Customers may, however, make deposits for either layaway or special order purchases. All of the stores have a standard policy that no refunds are allowed except for damaged merchandise or for very unusual circumstances when a customer's strong concerns warrant an adjustment. Any refunds made are subject to a [redacted] percent restocking fee for loss of sale opportunity, handling and other expenses. Merchandise could be exchanged.

All of the retail stores maintain inventory insurance, subject to varying amounts of deductibles for each store. The insurance does not cover any merchandise once it leaves the retail site. The last three months of the year are the busiest months for the stores.

In [redacted], [redacted] decided to institute a refund plan allowing the customers [redacted] days beginning [redacted] and ending [redacted]. The taxpayer claims that these sales are made under the Uniform Commercial Code (hereinafter "UCC") provision, section 2-326, Sale on Approval.

Prior to [redacted], and recommencing on [redacted], the taxpayer's invoice read:

1. [redacted].

The most significant change on the new invoice used between [redacted] and [redacted], found on the reverse side of the invoice, is as follows:

1. [redacted].

An internal memorandum to the taxpayer's managers and sales staff dated [redacted] states:

[redacted]

A representative of [redacted] stated that the damage or excess wear policy operated under a "due diligence" or reasonable care" standard. Therefore, if a table was destroyed in an automobile accident which was not the fault of the furniture buyer, [redacted] would have accepted the table for refund. Also, if a piece of furniture were to suffer water or fire damage, not the fault of the buyer, they would also have accepted the furniture for a refund.

Additional information is as follows:

[redacted] did not initiate a change in its inventory insurance during the new refund period. Insurance only covered merchandise in the store. The taxpayer states in its protest that it only insures against catastrophic loss. As such, the risk of such a loss once the inventories left the store for use in widely dispersed homes was remote and not worth covering by insurance.

[redacted] did not initiate the new refund policy during any of its [redacted] in [redacted], but it was used again during [redacted] and [redacted].

[redacted], in spite of saying that the new policy was to meet competitor terms, did not advertise the new refund policy on television or in any newspaper. The promotion was done by the sales staff. ([redacted] states that it was too late to advertise their refund plan in [redacted].) The facts contain no information about whether the policy was advertised in [redacted].

[redacted] did not use the new refund policy at its [redacted] store, stating that third party manufacturers did not agree to the new refund policy. [redacted] has provided no documentation to verify the third-party denials.

[redacted] did not participate in the new refund policy, allegedly because of the difficulty and cost of return furniture such as [redacted] and [redacted] seats. This rationale is not persuasive, however, because the taxpayer placed the cost and responsibility of return on the customer.

[redacted] did not report the sold [redacted] day inventory with the in-store unsold inventory to any applicable county for purposes of business inventory property tax. In its Protest, however, [redacted] states that this has been corrected.

Prior to the institution of the new refund policy, sales commissions to the sales people were accounted for at the time of the sale when the merchandise is paid for and taken from the store. With the new policy, the sales commissions are accounted for at exactly the same time, not when title allegedly passes under the UCC provisions.

Finally, [redacted] did not participate in the [redacted] temporary refund policy, allegedly due to [redacted] concerns. In [redacted], however, [redacted] did allow a [redacted] day satisfaction guarantee on its [redacted]. Transfer of title was not an issue with this guarantee. The [redacted] advertising during [redacted] stated in large letters at the top of the advertisement that satisfaction was guaranteed and that if the buyer was not completely satisfied within [redacted] days, the seller would buy it back.

DISCUSSION

Law

UCC section 2-326, "Sale on Approval. . ."[1] provides as follows:

> (1) Unless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is (a) a "sale on approval" if the goods are delivered primarily for use, [in contrast to resale] . . ..
>
> (2) Goods held on approval are not subject to the claims of the buyer's creditors until acceptance.

The official notes to this section provide that under a sale on approval, the seller undertakes a risk to satisfy the buyer with the performance of the goods sold. It is the right to return goods even if they meet the contract specifications. If the buyer's obligation as a buyer is conditioned not on his personal approval but on the article's passing a described objective test, the risk of loss by casualty pending the test is properly the seller's and proper return is at his expense.

UCC section 2-327, "Special Incidents of Sale on Approval. . .," section (1), provides, as relevant, that unless otherwise agreed, the risk of loss and the title do not pass to the buyer until acceptance; use of the goods consistent with the purpose of the trial is not acceptance but failure seasonably to notify the

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[1] This UCC section and section 2-327 also cover the conditions for a "Sale or Return," a situation where the goods are delivered primarily for resale. The UCC provisions for this type of sale, e.g., when risk of loss passes, etc., differ from those for "sale on approval" to the final consumer.

seller of election to return the goods is acceptance; and after due notification of the election to return, the return is at the seller's risk and expense.

I.R.C. § 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) provides that if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. Treas. Reg. § 1.446-1(a)(2) provides that a method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business in accordance with accepted conditions or practices in that trade or business will ordinary be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(a)(3) refers to section 451 for general rules relating to the taxable year for inclusion of income. Treas. Reg. § 1.446-1(a)(4) provides that a taxpayer must maintain accounting records sufficient to enable him to file a correct return. One essential in maintaining such records is taking account of inventory at the beginning and end of the year in computing taxable income in all cases where the sale of merchandise is an income producing factor. This section refers, as relevant here, to section 471.

Treas. Reg. § 1.446-1(c)(1)(ii) provides that generally under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii)(C) provides that under the accrual method, the method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it is in accord with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. The regulation then states, as an example, that a taxpayer engaged in a manufacturing business may account for the sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted or when title to the goods passes to the customers, whether billed or not.

Section 451 provides, as a general rule, that any item of gross income shall be included in taxable income in the year in which received by the taxpayer unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Treas. Reg. § 1.451-1(a) provides, as a general rule, that for an accrual method taxpayer, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. Treas. Reg. § 1.471-1 deals generally with the matter of when there is a need for inventories. It provides, as relevant here, that inventory should include goods acquired for sale or which will physically become a part of merchandise intended for sale. In this context, the regulation states that merchandise should be included in the inventory of a taxpayer only if title thereto is vested in the taxpayer.

Analysis

Issue 1

The UCC provisions at issue dealing with sales on approval to the final consumer are located in Article 2, "Sales," Part 3, "General Obligation and Construction of Contract." As provided in UCC section 2-326 and 2-327, in a transaction between a retailer and a final consumer, the parties may agree that a sale is considered a "sale on approval." Under this classification, the buyer is entitled to return the merchandise after a trial period even if the merchandise meets the requirements of the contract. During this period allowed for return, the seller retains risk for casualty loss and formal legal title. It is generally held that a merchant's statement of its policy in the invoice meets the concept of the parties' agreement.

A review of the UCC provisions on "sale on approval" and the case law has not revealed any reason that the taxpayer's sales method for the [redacted] does not fall under these provisions. Although it would seem fundamentally inconsistent with the spirit of "sale on approval" for the taxpayer to deduct [redacted] percent of the purchase price of the merchandise off the top upon return, no case has confirmed such a position. Further, the UCC provisions dealing with a "sale on approval" all contain the language, "unless otherwise agreed," to modify the provisions. Thus, the application of the provisions is apparently flexible, limited only by the contract being "unconscionable." UCC 2-302.

A [redacted] percent penalty on return would not seem to rise to a level of being unconscionable. This sense is also conveyed by the official comments on the UCC section. Under these circumstances, we do not believe that there is a case to be made that the sales provisions at issue used by the taxpayer do not meet the requirements of a UCC "sale on approval."

Issue 2

In this case, the taxpayer bases its case for deferral on several elements. First, it relies on Uniform Commercial Code provisions which provide for a particular time when title passes under certain sales arrangements. Next, the taxpayer cites to Treas. Reg. § 1.446-1(c)(1)(ii)(C) as allowing for an accrual method taxpayer to choose the time when title to the goods passes to the customer as the proper time for income recognition. The taxpayer also cites to Treas. Reg. § 1.471-1 as requiring goods to be included in the taxpayer's inventory when the taxpayer has title to such goods. Finally, the taxpayer cites to numerous cases to prove that under its circumstances, it can accrue when title passes under the UCC. In short, the taxpayer's argument is that state UCC law controls when title passes and that such title passage governs for Federal income tax law purposes. This is not correct.

Section 451

In Helvering v. Stuart, 317 U.S. 154, 161-162 (1942), the court said that "[s]ince the federal revenue laws are designed for a national scheme of taxation, their provisions are not to be deemed subject to state law 'unless the language or necessary implication of the section' involved so requires." Id. at 161. In the instant case, the necessary implication of the relevant provisions and case law does not so require.

Section 451 is the Code provision that controls when the question involves the amount of any item of gross income to be included in gross income. Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.451-1(c)(1)(ii) provide that generally income is to be included in the taxable year when all the events have occurred that fix the right to receive the income and the amount of income can be determined with reasonable accuracy. The thrust of this regulation was given its definitive statement in Schlude v. Commissioner, 372 U.S. 128 (1963). In that case, the Court said that all events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens earliest. Whether these events have occurred is not a question of state law. It is a question of fact.

In [redacted]'s case, payment was due and received at the time the merchandise left the store. Under Schlude, a sale occurred at this time for federal income tax purposes. The taxpayer is not entitled to defer income recognition of the sale for [redacted] days based on a mere contingency that the customer may return the merchandise in that time. Further, it is a reasonable assumption that the vast majority of customers represented by the sales at issue will not return the merchandise. Thus, income at the time of payment can be determined with reasonable accuracy. Consequently, the UCC provisions do not control for Federal income tax purposes. The language or necessary implication of the statutes and regulations governing income recognition from sales does not so require. Helvering v. Stuart, 317 U.S. 154, 161-162. See e.g., Central Point Software, Inc. v Global Software & Accessories, Inc., 880 F. Supp. 957 (E.D.N.Y. 1995) ("as between the transacting parties. . ., whether a transaction is a 'sale on approval' is one of state law,. . . this determination does not control the determination of rights. . .by the federal copyright statute." Footnotes omitted.)

Treas. Reg. § 1.446-1(c)(1)(ii)(C)

Contrary to taxpayer's argument, Treas. Reg. § 1.446-1(c)(1)(ii)(C) is not a fixed rule that a taxpayer may under any circumstances choose to accrue income from a sale when title to the goods passes to the customer. Rather, this part of the regulation is only a subpart of Treas. Reg. § 1.446-1(c)(1)(ii), which provides for the accrual of income when all events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Whether all events have occurred depends on all the facts and circumstances. In making such a determination of the facts, substance controls over form.

Substance Controls Over Form

It is well established that the economic substance of a transaction, rather than its form, controls for Federal tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Derr v. Commissioner, 77 T.C. 708 (1981). Labels, semantic technicalities and formal written documents do not necessarily control the tax consequences of a given transaction. Rather, the Court is concerned with economic realities and not the form employed by the parties. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Estate of Franklin v. Commissioner, 64 T.C. 752 (1975), affd. on other grounds, 544 F. 2d 1045 (9th Cir. 1976). It is also well established that "[a]t what point of time a sale takes place is to be determined from the totality of the circumstances." Hallmark Cards, Inc. v. Commissioner, 90 T.C.

26, 32 (1988). See, e.g., Paccar, Inc. v. Commissioner, 85 T.C. 754 (1985) acq. on another issue, 1987-2 C.B. 1, aff'd, 849 F.2d 393 (9th Cir. 1988). Courts will respect the form of a transaction when the retention of title is not a sham but has a commercial purpose apart from expected tax consequences. A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl 1960). See also United States v. Balanovski, 236 F.2d 298, 306 (2d Cir. 1956), cert. denied, 352 U.S. 986 (1957).

In Frank Lyon, the United States Supreme Court provided a summary of principles that are particularly relevant to the issue of how to determine ownership for Federal income tax purposes. Among other things, the Court noted that "'taxation is not so much concerned with the refinements of title as it is with actual command over the property. . ..'" 435 U.S. at 572-573, quoting Corliss v. Bowers, 281 U.S. 376, 378 (1930). In several cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. See, e.g., Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940).

In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," Commissioner v. Tower, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939). See also Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 266-267; Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). Thus, the fact that the documents contain labels that the transaction is a sale is not determinative of the actual character of the transaction. The issue of ownership is governed by the substance of the sales agreement, not labels used in the agreement. See, e.g., Tomerlin Trust v. Commissioner, 87 T.C. 876, 881-883 (1986).

Generally, a sale is a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-571 (1965). For purposes of Federal income taxation, a sale occurs upon the transfer of the benefits and burdens of ownership rather than upon the satisfaction of the technical requirements for the passage of title under state law. Grodt and McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). The question of whether the benefits and burdens of ownership have been transferred is essentially one of fact to be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. Id. See also Leahy v. Commissioner, 87 T.C. 56, 66 (1986) (transfer of the benefits and burdens of ownership govern for Federal tax purposes, rather than the technical requirements of passage of title under State law). Under this test, the determination of who has ownership of the merchandise at issue is a question of fact to be ascertained by reference to the sales documents, read in light of the attending facts and circumstances.

Among the factors to be considered in making the determination of whether a sale has occurred for Federal income tax purposes are: (1) whether legal title passes; (2) the manner in which the parties treat the transaction; (3) whether the purchaser acquired any equity in the property; (4) whether the contract of sale creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the purchaser is vested with the right of control or possession, and if so, the extent of such control or possession; (6) whether the purchaser pays property taxes following the transaction; (7) whether the purchaser bears the risk of loss or damage to the property; and (8) whether the purchaser will receive any benefit from the operation or disposition of the property. No one factor is dispositive of the issue of whether a sale has taken place. Grodt and McKay Realty, Inc., 77 T.C. at 1237-1238.

The application of these criteria to the facts in the instant case indicate that ownership passed from the taxpayer for Federal income tax purposes at the time of payment and removal of the merchandise from its store (hereinafter the "payment date"). The first factor is whether legal title to the property passed to the purchaser. Here, because of the UCC provision which the taxpayer purportedly applies to the transaction for [redacted] of its taxable year, legal title did not pass.

The passage of title, however, is not critical for the determination of whether a transaction is to be considered a sale. The Supreme Court is not so much concerned with the requirements of title as with actual command over the property. See e.g., Corliss v. Bowers, 281 U.S. 376. The transfer of legal title is not a prerequisite for a completed sale: "A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of the consideration and by which the purchaser secures immediate possession and exercises all the rights of ownership." Commissioner v. Union Pac. R.R. Co., 86 F.2d 637, 639 (2d Cir. 1936), affg. 32 B.T.A. 383 (1935). The fact that an agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property. Rev. Rul. 55-540, 1955-2 C.B. 39. As will be discussed infra, an equitable interest or equitable title did pass to the purchaser at the time the purchaser took control of the property and paid for it. Thus, while this factor supports the taxpayer's position, it is not a factor that is determinative of the outcome.

The second factor is the manner in which the parties treat the transaction, in this case, whether the parties treat the transaction as a sale at the time of the payment date. Although the taxpayer claims it does not treat the transactions at issue as sales until the passage of [redacted] days from the date of payment and the merchandise leaves the store, this is contradicted by the way the taxpayer handles sales commissions. For this purpose, the taxpayer treats the transactions as sales at the date of payment. This is exactly the same timing of sales commissions as when the taxpayer's "sale on approval" policy is not in effect. Also, until alerted by the examiner of the inconsistency, the taxpayer treated the sale on approval transactions as sales at the time of payment for the purposes of business inventory property tax. Overall, this factor does not support the taxpayer's treatment of the transaction. Indeed, it probably weighs at least as heavily on the side of a sale at the time of payment for the merchandise.

The third factor is whether the customer acquired any equity interest in the merchandise. Equity is generally the difference between the fair market value of the property and the outstanding balance of any loans on the property. Here, the taxpayer acquired 100 percent equity, completely paying for the property before removing it from the store. Except for circumscribed circumstances, this was the amount of the purchaser's investment at risk in the property. Further, the purchaser had all claim on any potential appreciation of the property. While the taxpayer was technically at risk for any decline in the value of the property for [redacted] days from normal wear and tear, such risk came into play only upon return of the property, and even then, the purchaser was docked at least [redacted] percent of the purchase price. This factor weighs on the side of a sale at the payment date.

The next factor is whether the transaction obligated the taxpayer to deliver a deed and obligated the customer to make payments to the taxpayer. Clearly, there was an obligation on the payment date to deliver legal title to the customer within [redacted] days if the customer did not return the merchandise. There was an obligation for the customer to pay for the merchandise, which payment occurred before the merchandise ever left the store. This factor weighs on the side of a sale at the payment date.

The fifth factor is whether the customer had the right of possession, and if so, the extent of it. In this case, the purchaser has complete dominion, control and possession of the merchandise. With such possession, the customer has the storage responsibility for the property, relieving the taxpayer of such. This factor weighs heavily on the side of a sale at the payment date.

The sixth factor is whether the customer paid property taxes with respect to the property. With respect to the customer, this provision has no applicability. With respect to the taxpayer, evidently in some states there would have been an inventory tax applicable to the "retained" merchandise. The taxpayer, however, did not make any adjustment for this consideration until after the issue was raised by the examiner. In such case, this factor also weighs on the side of a sale at the payment date.

The seventh factor is whether the purchaser bears the risk of loss or damage to the property. Under the provisions of the UCC sale on approval provisions, the seller does retain the risk of loss. The taxpayer, however, has limited this risk of loss. First, the fact that the merchandise is to be sold subject to a free return policy and the retaining by the taxpayer of the risk of loss is not advertised to the public. Only on the reverse side of the invoice does the taxpayer state the return policy and "sale on approval" terms of retaining title and risk of loss for [redacted] days. It is unlikely that more than a few customers read the legal provisions on the back of the invoice, and if they read, understood. Certainly, this is not general retail industry practice. Further, only in an internal memorandum is it stated that in order to be eligible for a refund from a theft loss, the customer must report the theft within [redacted]

Moreover, the risk of loss was technically on the taxpayer only in the event that the destruction was not the fault of the customer. Therefore, all risk of loss resulting from the fault of the customer is on the customer. If the customer damaged or destroyed the merchandise en transit through a fault of his, the risk of loss was on the customer. The customer also was at risk for any theft loss if he failed to report it to the police within [redacted] of the theft. The customer is also at risk for anything more than normal wear and tear of the property, the cost of returning the merchandise, should the customer decide to return it and for [redacted] percent of the cost of the merchandise on any returned merchandise. Finally, as per the taxpayer's statement in its protest, the taxpayer certainly understands its risk of loss was small, not bothering to maintain insurance on the merchandise once it left the store. On the basis of this analysis, while the taxpayer's maintaining some of the risk of loss weighs in favor of the taxpayer's position, there is also some weight on the side of treating the transaction as a sale at the payment date.

The eighth factor is whether the purchaser receives the profits from the operation and subsequent sale of the property. Here, to the extent it is applicable, the factor clearly goes to the side of a sale on the payment date. The customer immediately receives the profits from the operation or use of the merchandise, if any, and from any sale of the property. During the [redacted] days at issue, only the taxpayer could decide to sell the property and realize any proceeds from such sale. The taxpayer would have no claim on the property once it left the store other than under the contingent possibility the customer returned the merchandise. The decision to return the merchandise is solely the customers. Thus, the merchandise is completely within the dominion and control of the customer during the [redacted] days period.

Overall, applying the Grodt & McKay factors to the facts and circumstances of the instant case indicates that a sale in substance occurs when the customer pays for the merchandise and the merchandise leaves the store. Only the first factor, legal title, weighs entirely in the taxpayer's favor. Four of the eight factors weigh completely on the side of a sale, and the remaining three are split.

Treas. Reg. § 1.471-1

The taxpayer also refers to Treas. Reg. § 1.471-1 as authority for its deferral of income for the [redacted] days. This regulation provides that merchandise should be included in inventory if title thereto is vested in the taxpayer. From this, the taxpayer argues that as it technically retains title under state law for [redacted] days after it is paid for the merchandise and the merchandise leaves the store, there has been no sale for Federal income tax purposes.

This regulation and its references to title are inapplicable to this case. First, this regulation deals with the inventory accounting rules. It is not intended to apply to the determination of when a sale takes place.

Second, the title which the taxpayer continues to hold for the [redacted] days at issue under the UCC is bare legal title.

Equitable or beneficial title passes to the customer upon payment and the removal of the merchandise from the store. As discussed above, on the date the customer pays for the property, he acquires equity in the property; unrestricted possession and use of the merchandise; the responsibility for storage; much of the risk of loss; and the right to benefit from the property, to transfer it and to receive the proceeds of any sale. With this shifting of the benefits and burdens of ownership to the customer, the customer became the equitable owner of the merchandise. See e.g., Baird v. Commissioner, 68 T.C. 115 (1977).

Under these circumstances, the taxpayer did not have marketable title to the merchandise at issue. To be marketable, the title must embrace both the legal and equitable estates. Northouse v. Torstenson, 146 Neb. 187 (1945); Messir-Johnson Realty Co. v. Security Savings & Loan Co., 208 Ala. 541 (1922); 77 Am. Jur. 2d Vendor and Purchaser § 176 (1975), and cases cited therein. The significance of a marketable title is that it is the only kind of title that equity requires a purchaser to take. Queenin v. Blank, 268 Mass. 432 (1929). As such, the taxpayer under the circumstances of its use of the UCC provisions on "sale on approval" does not retain a title for the [redacted] days that could be readily sold to a reasonably prudent purchaser. Northouse v. Torstenson, 146 Neb. 187.

The title referred to in Treas. Reg. 1.471-1 is not such bare legal title. The regulation reads that "inventory should include all . . .goods . . .which have been acquired for sale or which will physically become a part of merchandise intended for sale." The merchandise at issue to which the taxpayer holds bare legal title is not such merchandise. It is not held for sale, nor, at taxpayer's option, will it become a part of merchandise intended for sale. It is already sold; physical possession has passed to the customer; and only at the customer's option, unlikely, will the merchandise be returned to taxpayer's inventory. This is not the sort of "title" referred to in the regulation.

Section 471 requires marketable title or at least a title where the seller could secure a decree of specific performance to acquire complete title. In the instant case, this is not so. Most of the benefits and, except for circumscribed circumstances, the burdens of ownership are with the customer. [redacted] could not file suit to obtain marketable title, for no further action on the part of the purchaser is required to obtain ownership. This is not be the type of title to which Treas. Reg. § 1.471-1 refers.

Consistency

The taxpayer's policy of sales on approval for [redacted] also violates the consistency requirements of the Code and regulations. Consistency is an important factor in clearly reflecting income under Treas. Reg. § 1.446-1(a)(2) and under the inventory accounting sections. See, e.g., Treas. Reg. § 1.471-2(b). Here, taxpayer has its policy of "sale on approval" for only [redacted] of the year, and that period only when it would defer income recognition on the sales until the taxpayer's next taxable year. This gives the taxpayer a permanent [redacted] month deferral (assuming the taxpayer implements the same policy at the end of each year) on a substantial income tax liability. Allowing taxpayer this right to implement this policy for [redacted] days of the year allows the taxpayer to manipulate income recognition.

Case Law

The cases cited by the taxpayer do not support its position. The taxpayer has cited numerous cases for the proposition that the courts have recognized that taxpayers have the power to specify when title passes and also for the proposition that the Service may not reject a method of accounting which is explicitly allowed by the Code and regulations. Particular cases cited are Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988), Orange & Rockland v. Commissioner, 86 T.C. 199, 215 (1986), Miami Purchasing Service Corporation v. Commissioner, 76 T.C. 818, 830 (1981), Epic Metals v. Commissioner, T.C. Memo. 1984-322, A.P. Green Export Company v. United States, 151 Ct. Cl. 628 (1960).

These cases are not apposite to the taxpayer's case. First, and in general, the issue of when and where a sale occurs depends on the facts and circumstances of the particular case. In none of the cited cases are the facts and circumstances those of the instant case.

In Hallmark Cards, the company held title to its Valentine Day cards and risk of loss until January 1, even though shipping occurred before. The right to receive payment did not occur until the passage of title. The court said that "[t]he objective is to determine at what point in time the seller acquired an unconditional right to receive payment under the contract." Id. at 32. The court found that until January 1, all events had not occurred.

Further, the court noted in footnote 6:

> The business reasons for petitioner's

> adoption of the January 1 passage of title and risk of loss are sound and have not been disputed. Thus, this is not a case where a taxpayer had deliberately manipulated the terms of sale so as to prevent income from accruing that it would otherwise become entitled to prior to the end of its taxable year. We express no opinion as to the tax consequences of such a situation.

The instant case is distinguishable. First, the taxpayer receives payment for the merchandise before it leaves the store. At this point the taxpayer has an unconditional right to the payment under the contract, subject to the potential contingency of a return.

In a slightly different but analogous context, the possibility of returns does not justify a taxpayer establishing a reserve for returned merchandised. "[A] liability does accrue as long as it remains contingent." Accrual occurs only when a liability is "fixed and absolute." Brown v. Helvering, 291 U.S. 193, 200-201 (1934). Except as specifically provided in the Code, no deduction is allowed for reserves for contingent liabilities. Denver & Rio Grande Western Railroad Co. v. Commissioner, 32 T.C. 43, 59 (1959), aff'd 279 F.2d 368 (10th Cir. 1960). See also, Ertegun v. Commissioner, 531 F.2d 1156 (2d Cir. 1976) (taxpayer selling records under contracts permitting distributors to return goods at full price up to [redacted] percent of their previous quarter's purchases; taxpayer could not anticipate returns by reducing gross sales by [redacted] percent. Similarly, the taxpayer here cannot fail to accrue the income because of the contingent possibility that some of the merchandise will be returned.

Further, this is not a case, as is Hallmark Cards, where the parties agree that there are valid business reasons for petitioner's retention of title and risk of loss for [redacted] days [redacted] of the taxable year. This is so notwithstanding the taxpayer's expert report.[2] In fact, this is a case of taxpayer

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[2] The taxpayer has attached an expert report with the protest. We do not find this report convincing. For example, the expert's opinion is that the "proviso that loss due to fire or theft would be reimbursed to the consumer by [redacted]. . . is a strong competitive differentiating point and enhances the customer's comfort with purchasing from [redacted]." Having made such a point, the expert rationalizes why such a strong competitive point is not publicly advertised. He does not even mention the

manipulation to prevent income accrual. Thus, this case is distinguishable from Hallmark Cards on the basis of footnote 6 of that case. Thus, when the totality of the circumstances are taken into account, the sales at issue occurred when the merchandise was paid for and taken from the store.

Nor are the other cases cited by the taxpayer's dispositive. The cited cases are Orange & Rockland v. Commissioner, 86 T.C. 199, 215 (1986), Miami Purchasing Service Corporation v. Commissioner, 76 T.C. 818, 830 (1981), Epic Metals v. Commissioner, T.C. Memo. 1984-322, and A.P. Green Export Company v. United States, 151 Ct. Cl. 628 (1960). To begin with, in none of these cases did the timing of the revenue recognition vary throughout the year. The taxpayers used the same procedures consistently during the year and from year to year.

More specifically, Orange & Rockland involved the sale of utility services, not merchandise. Further, under the public utility commission regulations applicable there, the unbilled December revenue at issue was not billable and termination of performance not permissible until after the cycle meter reading date in January. The court's closing comments show that this was a deciding factor in its decision. Epic Metals, while tangentially related to the instant case, is a case determining whether inventories are required, not a determination of when a sale took place. To the extent the taxpayer's argument is relying on Treas. Reg. § 1.471-1, we refer to our above discussion on this regulation.

Both Miami Purchasing Service Corporation v. Commissioner and A.P. Green Export Company v. United States involved whether the particular entities were Western Hemisphere trade corporations under section 921. Such a determination depended, inter alia, on what percentage of gross income came from outside of the United States. These and many similar cases looked carefully at where and when title and risk of loss passed, with varying results.

In Miami Publishing, the court found that the sales occurred in the United States on the basis of the use of the terms, F.O.B. and C.I.F., where there was no indication that the parties agreed otherwise. A.P. Green Export Company v. United States involved whether the retention of title for sales to customers outside of the United States made the sales foreign sales. The issue was whether the retention of title was more than a sham. The court

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fact that details of this policy are not even spelled out on the invoice.

found enough substance in the export company's retention of title and risk of loss until arrival of the goods at the foreign destination to hold that the primary purpose of the particular structure of the transaction was not tax avoidance.

For example, the court in A.P. Green Export Company stated:

> Retaining title until delivery served a legitimate business purpose apart from the expected tax consequences. A moment's contemplation of the current headline disputes among countries all over the world underscores the prudence of exporters who retain title to goods until delivery. A sudden trade embargo, a seizure or a nationalization of an industry, a paralyzing nationwide strike.

There is a substantial difference between retaining risk of loss during the period of international shipment there and the risk of loss for [redacted] days where the merchandise is located locally in the customers home. Further, in this regard, in A. P. Green Export Company, title passed at the time the customer came into possession of the goods.[3] Given these differences between the facts in the instant case and those in the cases cited, they do not make the taxpayer's case. We conclude that the stronger position is against allowing the taxpayer to defer the income at issue for the [redacted] days.

Hazards

Based on the above, we do not think that the taxpayer is legally entitled to defer the income recognition from the end of year sales for [redacted] days. Nevertheless, we do recognize that the determination in a court will turn on facts and circumstances. Thus, the issue is not without risk.

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[3] As these were export sales, it is also likely that payment was via bank letters of credit. In such case, payment would not be made until the merchandise was in the possession of the buyer.

If you have any further questions, please do not hesitate to contact us.

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